

DEVICE INVESTING

Water Street: Finding a Middle-Market PE Niche

The private equity (PE) deals that have attracted the most attention in the device industry have been the major transactions that have occurred primarily in orthopedics—deals like the acquisitions of **Biomet Inc.**, **Encore Medical Corp.**, and **Tornier SA**. There are also signs of increased interest on the part of PE investors in later-stage device start-ups; one recent example is **Evalve Inc.**'s recently closed \$60 million Series D round. (See "Evalve, Mitralign Deals: Heart Valves Draw New Device Investors," IN VIVO, December 2007.) While many PE investors appear to be focusing on the high and low ends of the device investment spectrum, Chicago-based Water Street Healthcare Partners is a firm carving its niche out of middle-market opportunities.

A new name to many, Water Street has more experience than one might assume for a firm founded in 2005. The group's roots go back to 1997, when basically the same core team, headed by Tim Dugan, Kip Kirkpatrick, and Jim Connelly, directed the health care practice at First Chicago Equity Capital. Following a series of mergers—initially First Chicago and Bank One, then Bank One and JP Morgan—the group's name and source of capital changed, becoming One Equity Partners, but the people and business strategy remained the same, culminating in their spin-off two years ago into Water Street, founded by Dugan, Kirkpatrick, and Connelly.

Focused exclusively on health care, the firm concentrates on medical devices, specialty distribution, and specialty services, with roughly 50% of their current portfolio in devices. Water Street also looks for specialty pharma opportunities. "Any life science tools company that would fit a later-stage growth equity or buyout model would also be a good fit for us," Tim Dugan, managing partner, says, noting that specialty pharma

and generics companies that fit that model are of particular interest. "What we don't do are early-stage device investing, early-stage molecule development, or traditional facilities-based providers such as hospitals," Dugan adds.

Defining what constitutes a private equity firm today is something of a moving target. Tim Dugan characterizes Water Street as "focused on companies with established market positions, generating revenues and profits, as opposed to companies that are still trying to either demonstrate their underlying technology or establish a market presence with an approved product." Within that context, Water Street looks for middle-market investments, targeting acquisitions of \$50-\$500 million. The firm's first fund is \$370 million, of which it has invested roughly two-thirds. (There has been speculation that Water Street is raising another fund, and while its executives won't comment, people familiar with the firm suggest it is likely to raise another fund this year.)

According to Tim Dugan, Water Street's team's strategy, developed over the course of a decade of working together, is to "find an industry niche where we think there is an opportunity to build a market-leading company." Almost by definition, that means a market segment not dominated by and not a high priority for a large company.

Indeed, the firm's primary source of potential investment opportunities are major public health care product companies. Here, Water Street executives spend significant time cultivating relationships aimed

at identifying assets (e.g., product lines or entire divisions), which while not officially on the market, are no longer a high priority or top performer for the large company and could deliver value when teamed with a Water Street portfolio company. These industry relationships have resulted in Water Street deals involving several major device companies, including **Stryker Corp.** (**Physiotherapy Associates Inc.**—rehab/physiotherapy products), **Medtronic Inc.** (**Alpine Biomed Corp.**—diagnostics), and **Matria Healthcare Inc.** (**Facet Technologies LLC**—lancets and lancing devices). Prior to founding Water Street, the team also completed investments with **Smith & Nephew PLC**, (**AbilityOne Corp.**—physical and occupational therapy products), and **Johnson & Johnson** (**Medex Inc.**—fluid and drug delivery systems).

Tim Dugan points to Alpine Biomed as a good example of Water Street's strategy. "Among the areas we like a lot are niche diagnostic segments," he says. Alpine is a small, private company, generating around \$50 million in revenue from technologies in the gastro- and neuro-diagnostic areas, where they are the market leaders. Both of these are relatively small markets (several hundred million dollars each) with moderate growth rates (mid-to-upper single digits). Water Street invested in Alpine and simultaneously led it in acquiring the neuro-diagnostic product business from Medtronic.

"We see Alpine's markets as attractive niches supporting disease states that have reasonable growth rates, and are segments

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that are not areas of focus for large companies because they're not large enough and not growing rapidly enough," Dugan explains, adding that most of Alpine's competitors are small, under-capitalized companies. By providing capital and strategic guidance, Water Street looks to enable Alpine to grow both organically and strategically through acquisitions to further expand and strengthen the company's position as the leader in those markets.

Water Street's niche strategy does not prevent the firm from investing in companies working in major product markets; it simply requires the firm to identify a specific, under-served segment of that larger market. An example of that approach is Water Street's investment in Facet Technologies, which serves the diabetes/blood glucose monitoring market, a fairly-well consolidated area dominated by larger players. Facet is the global leader in providing lancing systems, lancing devices, and lancets to point-of-care diagnostics companies, with a 50% market share. Diabetes is, by far, its biggest market, where it designs, manufactures, and sells lancing systems to the largest blood glucose monitoring companies. "That's our unique way of participating in the diabetes marketplace as a market leader," Tim Dugan says.

A similar example is **Precision Dynamics Corp.**, which is in the growing patient safety products market, where it is the leader in patient identification wristbands. Dugan points to Precision Dynamics as a strong opportunity for Water Street to build a platform company in what is becoming an increasingly important area—patient safety—within multiple systems in hospitals. One such example is medication safety, where first bar coding and then RFID systems are now incorporated within patient wristbands to ensure that patients receive the proper medical regimen. "We're not proposing that, through patient identification, we offer the complete solution, but we're playing an important role working with other companies to develop an integrated solution to this problem," he says.

Tim Dugan emphasizes that Water Street can get a very attractive rate of return by investing in companies that play that type of supporting role in larger product markets. "We tend to think of ourselves as somewhere between a pure financial buyer and a strategic

investor, in terms of the way we operate," he explains. Where Water Street most resembles a strategic investor is when it invests in a true platform company.

Dugan points to Medex Inc., a former portfolio company acquired by **Smith's Group PLC**, that developed a line of critical care products, as a platform opportunity. Following Water Street's investment, it helped Medex acquire the peripheral IV catheter business from J&J, and expanded the company's product line, so it became the leader in offering complete fluid and drug delivery systems. "Once we have a company of that scale set up with a system being sold into a specific customer base, we become a very attractive channel through which to sell newer developing technologies. We shift gears from being a relatively modest mid-tech player to offering at least the option of becoming the source through which new, higher technology products get to market," he says.

Water Street has used this niche strategy to carve out its own space in an otherwise increasingly crowded PE health care marketplace. There not many other PE firms active in the mid-market health care space, and Tim Dugan also believes Water Street is also one of the only firms working aggressively to find and develop opportunities from larger companies. "We have built a specialty practice around carving product lines or divisions out of the big public health care companies," he says, claiming Water Street has done more of these complex carve-outs than anyone else.

Dugan emphasizes that Water Street is not looking to take distressed businesses off the hands of large companies. The firm is looking for situations such as more mature market segments or technologies that are no longer a top priority from either a corporate or customer perspective. In Dugan's view, Water Street's approach is much like a lifecycle management strategy. "There are businesses that large companies appropriately choose no longer to invest in because resources are going to other higher priority products that are generating higher returns. At that point, our strategy is better suited to growing these businesses by bringing focus, management resources, and capital," he explains.

In addition to acquiring businesses from large companies, Water Street will also enter into partnership deals where the parent com-

pany maintains a significant ownership position through recapitalization of a subsidiary or division. In this kind of deal, Water Street acts as the lead investor, commits capital, maintains day-to-day oversight, and may recruit additional management to the new company. The parent firm has an active board role and receives a combination of cash and a note at closing, in addition to equity in the new company. This retained ownership enables the parent company to realize a second payment in the future without devoting any additional capital or management talent to the company, Dugan points out.

Water Street executives see their strategy as not just different than the huge PE health care deals that have garnered the most attention recently, but also as being better suited to the nature of the health care business, claiming their middle-market area has actually produced better results than the high-end of the buyout market. The reason Tim Dugan and his partners spun-off from JP Morgan was their belief that the fund there was getting too big. Dugan's view is that health care is a middle market, not a big fund/big dollar business. "If you look at the companies our team has built, they generally start in the \$50-\$150 million revenue range, and we build them to the \$200-\$400 million range. That's a middle-market operation and there are a lot of health care segments where opportunities exist for us to execute our strategy," he states.

In Dugan's view, the large PE health care transactions have been anomalies, driven largely by the debt financing that was—but no longer is—available as a result of the current credit crunch. "The pendulum had swung too far out of balance and was at the outer edge of the prices that private equity firms were willing to pay, resulting in putting leverage on those businesses that is not healthy or sustainable," he says.

Where will the market for these larger transactions end up following this correction? According to Dugan, "I expect we'll return to a more normal state of affairs where the big health care transactions in the higher growth categories are—as they should be—the domain of the strategic buyer, not the private equity firm."

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